



**MINUTES
REGULAR MEETING
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**Friday, December 15, 2006
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Dr. Keith Meredith, Chair of the ASRS Board, called the meeting to order at 8:38 a.m., MST.

The meeting was teleconferenced to the ASRS office at 7660 E. Broadway, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Dr. Keith Meredith, Chair
Mr. Michael Townsend, Vice Chair
Mr. David Byers
Mr. Jaime Gutierrez (via teleconference)
Mr. Chris Harris
Ms. Anne Mariucci
Mr. Karl Polen
Mr. Lawrence Trachtenberg
Mr. Steven Zeman

A quorum was present for the purpose of conducting business.

2. Tribute to Former Trustee and Longtime Friend of the ASRS, Dr. Merlin DuVal

Dr. Keith Meredith, Chair, and Mr. Paul Matson, Director, recognized the passing of former Trustee and longtime friend of the ASRS, Dr. Merlin DuVal. Dr. DuVal was recognized as a dignified leader, a visionary, an intellect, a statesman and a friend. Mr. Matson shared several comments he had received from former Director, LeRoy Gilbertson, former ASRS Board Chair, Alan Maguire, former ASRS Board Chair, Ray Rottas and former ASRS Vice-chair, Norman Miller; all of which expressed their great sense of loss as well as appreciation for their time with Dr. DuVal.

3. Approval of the Consent Agenda

Motion: Mr. Michael Townsend moved to approve Refunds, Death Benefits and Retirements;

And

Approve the System Transfers;

And

Approve the minutes of the November 17, 2006, Regular Session of the ASRS Board

Mr. Steve Zeman seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

4. Presentation, Discussion and Appropriate Action Regarding the 2007 Legislative Initiatives

Mr. Pat Klein, Assistant Director, External Affairs, and Ms. Lesli Sorensen, Government Relations Officer, addressed the Board regarding the 2007 Legislative Initiatives. Mr. Klein stated that throughout the summer, External Affairs (EA) received more than 40 suggestions offered by the ASRS staff and Trustees concerning plan design issues; plan inefficiencies, inconsistencies, and inequities; administrative concerns; and others. EA researched and discussed each suggestion in conjunction with Trustees, Executive Management, and other internal staff.

The current proposals represent an overarching legislative theme: to ensure the longevity and stability of the Fund. The ASRS' legislative proposals will help mitigate the upward pressure on the pension contribution rate and move toward industry standard Long Term Disability (LTD) structures. The 2007 initiatives will assist in preventing further large spikes in the contribution rate while providing benefits that will continue to attract and retain highly qualified public servants.

Preliminary thoughts on what the ASRS' position should be on the following legislative issues have been outlined. However, A.R.S. §38-714(E) states that "[t]he board shall not advocate for or against legislation providing for benefit modifications, except that the board shall provide technical and administrative information regarding the impact of benefit modification legislation." ASRS staff has worked in conjunction with the Assistant Attorney General to determine which issues the ASRS may formally support or oppose. For those issues that modify benefits, it has been noted that the role of the ASRS will be to provide information.

2007 Legislative Issues

ASRS: Plan Design Omnibus

- Average Monthly Salary
- Rule of 85
- Enhanced Refunds
- Overpayment recoupment
- Membership Date Clarification

ASRS: Long Term Disability Omnibus

- Membership Definition
- Social Security Offsets
- Pre-existing Conditions
- Overpayment recoupment

ASRS: Investment Management Omnibus

- Minimum Qualifications Elimination
- Confidential Information
- Increased Foreign Investment Cap

ASRS: Investment Management; Procurement Exemption
Investment Management Procurement Exemption

ASRS: Social Security Coverage

Term “agreement” no longer necessary—conforming to federal use of “coverage”

ASRS: Military Service Credit

- Military Call-up
- Death and disability credited service

ASRS: LTD; Unclaimed Property

Exempts the ASRS and LTD Trust Funds from statutory unclaimed property requirements, and establishes in lieu ASRS unclaimed property procedures.

Supplemental 401(a): Matching Contributions

Employer is not required to deposit matching contributions to the plan in which the employee participates and IRC limits need not be met prior to matching to supplemental 401(a) plan

Motion: Mr. Steve Zeman moved to accept the 2007 legislative initiatives presented by staff, with the intention of supporting all initiatives except the Rule of 85 and Average Monthly Salary provision, on which the Board should have a neutral position, but shall provide information to the Legislature on the impact of the initiatives on the Fund. Staff may make all language changes and negotiate as necessary to obtain the most effective and efficient legislative provisions within the construct of today’s proposals.

Mr. Karl Polen seconded the motion.

Dr. Keith Meredith called for discussion. Mr. Dave Byers expressed concern about the LTD pre-existing conditions modifications, specifically the change from a three month look back to a six month look back. Mr. Byers noted that perhaps the change would prevent individuals with genuine problems from receiving the benefit. Mr. Klein explained the change would conform to the industry standard and would help mitigate the potential for fraud.

Motion: Mr. Dave Byers moved to remove the LTD Omnibus Legislation from that motion and to vote separately on that issue.

There was no second to the motion.

Dr. Meredith returned to the original motion introduced by Mr. Steve Zeman.

By a vote of 8 in favor, 1 opposed, 0 abstentions, and 0 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding the System Proposal

Mr. Pat Klein updated the Board regarding the System Proposal. Mr. Klein stated that in July 2006, staff, with the assistance of Mercer Human Resources Consulting, presented to the Board the results of an analysis conducted to potentially allow System members to transfer into the Defined Benefit Plan at a cost in order to guarantee their pension benefits. The Board authorized the timeline during which members would be presented with the proposed model and provide feedback to assess their willingness to support the proposal.

In September, ASRS staff sent information on the proposal to all System members and conducted 17 statewide meetings in October to discuss the proposal. Many System members also provided very thoughtful letters and emails about their concerns regarding the proposal.

Results of Survey

Feedback	Number	% of Total Population	% of Total Respondents
No response	1157	60	N/A
Responding	788	40	N/A

Breakdown of Responding Members

Feedback	Number	% of Total Population	% of Total Respondents
Support Proposal Support as is = 499 Support if modified = 4	503	26	64
Oppose Proposal	244	12	31
Neutral on Proposal (returned form but did not indicate support or oppose)	41	2	5

There are a total of 1,945 System members in retired and non-retired status (approximately 1,700 retired, 90 active and 155 inactive and non-retired). The analysis clearly indicates limited support by System members to have the ASRS move forward with legislation on their behalf. As evidenced by annual member statements, other communications, and System meetings, System members are cognizant of the fact that a portion of their benefit is not guaranteed and may be subject to reduction if the funded status of the System falls below 95 per cent. Through their collective voice, members have indicated they are willing to bear that risk without any additional action on the part of the Board at this time. The ASRS will continue to monitor the System's assets and liabilities to determine if it is prudent at some future date to make any changes to the System Asset Allocations.

6. Presentation, Discussion and Appropriate Action Regarding the Total Fund Performance Overview for the Period Ending September 30, 2006

Mr. Terry Dennison, Principal, Mercer Consulting, addressed the Board regarding the Total Fund Performance Overview for the period ending September 30, 2006, highlighting specific areas of interest and concern.

Mr. Dennison reported on the Total Fund Performance for the period ending September 30, 2006.

	Quarter	1 Year	3 Years	5 Years	10 Years	Inception
Total Fund	3.9%	10.1%	12.0%	8.6%	8.9%	10.9%
Benchmark*	4.9%	10.2%	11.4%	7.9%	7.7%	10.7%
Excess Return	-1.0%	-0.1%	0.6%	0.7%	1.2%	0.2%

* Interim Benchmark: 55% S&P 500, 28% LB Aggregate, 16% MSCI EAFE/ACW ex. US(1), and 1% NCREIF+100 bps.

Note: Interim Benchmark incorporates a proration of 5% real estate.

Policy History:

- 7/1/75-12/31/79 – 40% S&P 500/60% LB Aggregate
- 1/1/80-12/31/83 – 50% S&P 500/50% LB Aggregate
- 1/1/84-12/31/91 – 60% S&P 500/40% LB Aggregate
- 1/1/92-12/31/94 – 50% S&P 500/40% LB Aggregate/10% EAFE
- 1/1/95-6/30/97 – 45% S&P 500/40% LB Aggregate/15% EAFE
- 7/1/97-12/31/99 – 50% S&P 500/35% LB Aggregate/15% EAFE
- 1/1/00-9/30/03 – 53% S&P 500/30% LB Aggregate/17% EAFE
- 10/1/03-present – 53% S&P 500/26% LB Aggregate/15% MSCI EAFE/ACW ex. US(1)/6% NCREIF+100 bps.

(1) MSCI EAFE/ACW ex. US Benchmark is the MSCI EAFE prior to 10/1/05 and the MSCI ACW ex. US thereafter.

7. Presentation, Discussion and Appropriate Action Regarding the U.S. Mid Cap Equity Reporting on the Period Ending September 30, 2006

Mr. Gary Dokes, Chief Investment Officer, Mr. Dan Kapanak, Manager of Investment Analysis, and Mr. Terry Dennison addressed the Board regarding the U.S. Mid Cap Equity Reporting on the period ending September 30, 2006. As of September 30, 2006, the total market value of the ASRS Mid Cap asset class was \$1.5 billion and represented approximately 6% of the ASRS total fund. Mid Cap Equity assets are currently managed in seven portfolios: four active portfolios and three passive portfolios.

Franklin Portfolio Associates underperformed the benchmark for all periods evaluated except since inception. The portfolio placed in the bottom quartile of the universe for all periods except inception. Mercer rates this product A (above average probability of outperformance).

Mr. Steve Zeman and Mr. Chris Harris expressed concerns about the consistent underperformance of Franklin Portfolio Associates. Mr. Dennison explained that Mercer continues to give them a rating of A due to the probability of above average performance. Mr. Dokes stated that further investigation would be made into the benefit of retaining Franklin Portfolio Associates and a recommendation would come to the Board in the near future.

Wellington Management outperformed its benchmark for all periods. The portfolio placed above the universe median for one year and three years. Mercer rates this product A (above average probability of outperformance). Mr. Dennison noted that effective July 1, 2006, Phillip Perelmutter, portfolio manager of the Mid Cap Opportunities strategy, was appointed as a Managing Partner succeeding Jack Ryan. Mercer is not concerned with Perelmutter's appointment and is confident in his abilities and has high conviction in the Mid Cap Opportunities strategy.

NorthPointe Capital outperformed its benchmark and the universe median for all periods evaluated. Mercer rates this product B (average probability of outperformance).

Cramer Rosenthal McGlynn outperformed its benchmark and the universe median for all periods evaluated. Mercer rates this product A (above average probability of outperformance).

State Street Global Advisors is tracking the S&P Mid Cap 400 Index as expected. Mercer does not rate this product.

The Arizona State Retirement System E3 portfolio has tracked the Mid Cap Growth Blended Benchmark as expected. The Arizona State Retirement System E4 portfolio has tracked the Mid Cap Value Blended Benchmark for all periods evaluated.

8. Presentation, Discussion and Appropriate Action Regarding the U.S. Equity Small Cap Index Portfolio

Mr. Gary Dokes and Mr. Mike Viteri, Manager of Portfolios and Trading, addressed the Board regarding the U.S. Equity Small Cap Index Portfolio. Mr. Dokes stated that on October 20, 2006, the ASRS Board approved the new ASRS Asset Allocation Policy, which included the ASRS Total Fund and asset class policy targets/ranges. Currently, the ASRS benchmarks U.S. Equity Small Cap managers against the Russell 2000 Index (DFA-R2K Value, Batterymarch-R2K Growth, Mellon Capital-R2K). Times Square manages a Small/Mid-Cap (SMID) mandate benchmarked against the Russell 2500 Growth Index.

Consistent with the new ASRS Asset Allocation Policy and effective January 1, 2007, the ASRS Small Cap Equity asset class will be benchmarked using the S&P 600 Index. Specific ASRS Small Cap managers' performance will be benchmarked against their respective core, value or growth indices. Time Square will maintain their Russell 2500 Growth Index benchmark.

Though the ASRS active Small Cap equity managers indicated that from a portfolio construction process, changes in the portfolios would be negligible as a result of their migration to the new small cap benchmark, Mellon Cap (ASRS Small Cap Passive) does not currently manage a S&P 600 Index commingled mandate. As such, the Investment Management Division (IMD) recommends the creation of an internally-managed S&P 600 Index passive portfolio (E6).

Motion: Mr. Larry Trachtenberg moved to approve the creation of an internally-managed S&P 600 Index passive portfolio (E6);

And

Approve the funding of the E6 portfolio with approximately \$800 million originating from the Mellon Cap Small Cap Index portfolio and residual dollars associated with rebalancing of the ASRS Small Cap Equity to its new ASRS asset class allocation policy targets of 7%.

Mr. Karl Polen seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

9. Presentation, Discussion and Appropriate Action Regarding the Supplemental Retirement Savings Plan (SRSP) Plan Statement Amendment

Mr. Pat Klein and Ms. Lesli Sorensen updated the Board regarding the Supplemental Retirement Savings Plan (SRSP) Plan Statement. Ms. Sorensen stated that in 2001 the Legislature permitted the ASRS to establish a 401(a) Defined Contribution Plan, called the Supplemental Retirement Savings Plan (SRSP), as a supplement to the Defined Benefit Plan.

As the statute was originally drafted, the ASRS had difficulty in securing favorable tax treatment from the IRS, and full implementation was delayed. Also in 2001, the Legislature established a Deferred Retirement Option Plan (DROP) that would have allowed a member to return to work after retirement and buy 2-for-1 service credit. In December 2001, the Board approved the original SRSP, and the prior Director signed the SRSP Plan Statement in January 2002. In August 2003, the Board adopted the First Amendment to the Plan Statement that conformed the SRSP to IRS requirements.

Unfortunately, the DROP would have had a significant negative impact on ASRS contribution rates, and the ASRS took action last session to have the DROP Program legislation repealed. As the SRSP was designed in part to be a receptacle for the DROP, it was important to wait until the DROP was repealed before continuing implementation activities for the SRSP.

Since the DROP legislation has been repealed and the RFP was awarded to Nationwide Retirement Solutions (NRS), staff reviewed the contents of the approved SRSP Plan Statement and Trustee approval is needed for a final set of amendments (e.g. a revised Plan Statement) to the SRSP that will conform the SRSP to 2003 statutory amendments and be optimal in a post-DROP environment. NRS suggested some minor changes to conform to their current practices.

Plan Statement Amendment

Below is a summary of and reasoning for the changes to the Plan Statement (last modified July 1, 2003). The Amendment:

- Removes references to the Modified DROP Program.
- Clarifies that Participants earn service credit in the SRSP at the same rate as the DB Plan.
 - Including provisions that 9-month employees earn 1 year for 9 months worked and that refunded service will zero-out the SRSP service credit. Still includes provision that purchased service counts towards SRSP service credit.
 - Necessary for the ASRS to be able to calculate the vesting service required by statute.
- Creates separate employee enrollment and employee contribution election processes.
 - Since the statute allows an employer to contribute “matching” money to someone who is not contributing individually, we needed a mechanism to enroll a member without requiring the member to elect a contribution amount.
- Modifies contribution election options to comply with amended statute (A.R.S. §38-953) and IRS requirements.
 - 2-year irrevocable election to participate; % of compensation.
- Allows the Employer to establish a contribution schedule for employee contributions.
 - Participant may elect between a fixed percentage and the Employer’s graded schedules.
- Allows the Employer to match all Employees, rather than only those meeting the Plan eligibility age.
 - Provides for Employer flexibility and authorized by statute.
- Allows loans on the Total Vested Account.
 - Currently allows loans from Employer Matching Contributions or individual rollover accounts.

- Requires someone to return to employment within one year in order to receive previously suspended and unvested employer matching contributions (currently it is open-ended).
 - Staff perspective is that it was better to place a time-limit on someone receiving these reinstated contributions in order to make the SRSP more administratively feasible.
- Conforms spousal consent requirement for beneficiary designations to the DB Plan and other standard government DC Plans.
- Allows a loan on the Total Vested Account.
 - Currently disallows loans on Participant contributions made via the 414(h)(2) pick-up.
- Modifies the appeals procedure to match current ASRS practice and eventual Administrative Procedure Act Rules.
 - Current procedure is boilerplate rather than customized.
- Allows the Director to retain and terminate the Vendor, rather than the Board.
 - To facilitate changes and to conform to the Management and Oversight Process.
- Makes other technical, clarifying, and conforming changes.

Motion: Mr. Steve Zeman moved to adopt the ASRS Supplemental Retirement Savings Plan as it has been amended and restated in the form circulated to the Board and authorize and direct the Director of the ASRS to execute such amended and restated Plan for and on behalf of the Board.

Ms. Anne Mariucci seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

10. Presentation, Discussion and Appropriate Action Regarding the Board Governance Handbook

Mr. Paul Matson addressed the Board regarding the Board Governance Handbook. The Board Governance Handbook states that as part of the governance process, "This Handbook will be reviewed by the Board at least annually or more often if necessary. It will be updated at the Board's direction." Mr. Matson explained to the Trustees that there were three distinct elements to note while reading through the Handbook: references to substantial annual responsibilities, key items to be reviewed, and recommended changes. Mr. Matson then presented key items in the Board Governance Handbook.

Motion: Mr. Michael Townsend moved to approve the Board Governance Handbook changes as recommended by the Board and ASRS staff.

Mr. Dave Byers seconded the motion.

By a vote of 9 in favor, 0 opposed, 0 abstentions, and 0 excused, the motion was approved.

11. Presentation, Discussion and Appropriate Action Regarding the Board Governance Evaluations

Dr. Keith Meredith asked the Trustees to complete their Board Governance Evaluations and submit them to him by the end of January.

12. Director's Report

Mr. Paul Matson provided a general update regarding items in the Director's Report. He stated that in the Budget section there is a travel expenditure spreadsheet tracking all out of state travel. This item had not been included in the Board book during 2006 and was therefore presented for the entire 2006 back period. This report will now be included in the Board book from this point forward.

13. Possible Presentation Regarding Board Committee Updates

Mr. Jaime Gutierrez, Chair, External Affairs Committee, stated that the External Affairs Committee would be focusing on the legislative session.

Mr. Larry Trachtenberg, Chair, Investment Committee, had no comments.

Mr. Michael Townsend, Chair, Operations Committee, reported that the IT plan is moving forward.

14. Board Requests for Agenda Items

There were no requests for future agenda items.

15. Call to the Public

Dr. Mary Murphy, Arizona All Schools Retirement Association (AASRA), requested that Dr. Meredith read her comments that clarify to the Board and attendees of the Board meeting regarding the Coalition's position on the Graded Multiplier Legislation. The Coalition only supports this proposed equity change at this time if the legislature would provide funding to offset the negative impact on the ASRS and contribution rate.

16. The next ASRS Regular Board meeting is scheduled for Friday, February 16, at 8:30 a.m., at 3300 N. Central Avenue, 10th Floor Board room, Phoenix, Arizona.

17. Adjournment of the ASRS Board

Dr. Meredith adjourned the December 15, 2006 Board meeting at 11:42 a.m.

ARIZONA STATE RETIREMENT SYSTEM

Anne Schrode, Secretary

Date

Paul Matson, Director

Date